

Internal Revenue Service
memorandum

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Br5:RLChewning

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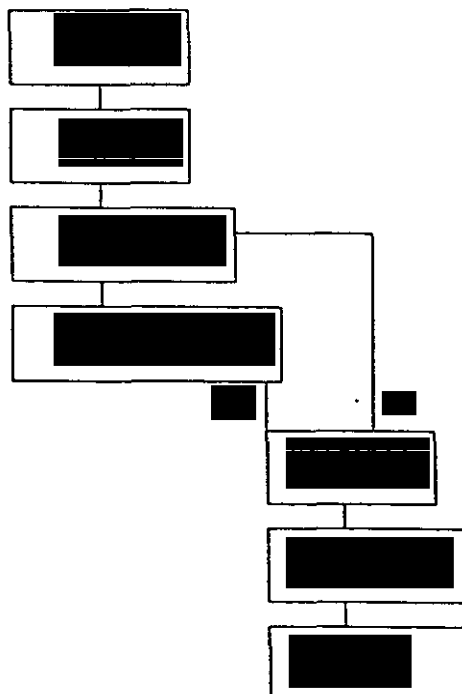
to: Bruce Levy
Joseph Calderero

from: Branch Chief CC:INTL:Branch 5 *Robert Hecker*

subject: [REDACTED] --LIFO election by [REDACTED]

THIS DOCUMENT CONTAINS PRIVILEGED INFORMATION UNDER SECTION 6103 OF THE INTERNAL REVENUE CODE. THIS DOCUMENT ALSO INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYERS INVOLVED. ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

This is in response to your informal request for legal advice as to whether [REDACTED], a U.K. corporation, may elect LIFO for purposes of determining its earnings and profits. In our opinion, [REDACTED] may elect LIFO even though it did not use LIFO, because of U.K. law and U.K. GAAP, for books and records, reports to shareholders and U.K. income tax purposes. The operative facts as we understand them are detailed below. The [REDACTED] corporate group is as follows:



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All of the domestic corporations in the [REDACTED] group file a consolidated Federal income tax return with a fiscal taxable year ending [REDACTED]. [REDACTED] has a fiscal taxable year ending [REDACTED]. [REDACTED] has been owned by the [REDACTED] group since the [REDACTED]s.

In a letter dated [REDACTED], [REDACTED] adopted certain accounting methods and practices for purposes of determining the earnings and profits under section 902 of its controlled foreign corporations. Among the specific accounting methods elected were the election under § 1.902-1(g) to apply the principles of section 964 for purposes of computing [REDACTED] earnings and profits and the election of the LIFO inventory method for [REDACTED], effective for taxable year ended [REDACTED] with regard to "[REDACTED]" and "[REDACTED]". The domestic corporations in the [REDACTED] group also have elected LIFO. No inventories exist in [REDACTED] and [REDACTED].

[REDACTED] filed in the name of [REDACTED] Form 970, Application to Use LIFO Inventory Method, and other detailed inventory information as required by § 1.472-3 with the Federal income tax return for its year ending [REDACTED]. On that form, question 3b "Will you include in income over 3 tax years any adjustments that resulted from changing to LIFO?" was answered affirmatively. [REDACTED] also indicated on the form that it issued reports to its shareholder in which the FIFO inventory method was used to determine income, profit or loss. [REDACTED] used the FIFO inventory method for purposes of its U.K. tax return and books and records and reports to its shareholder because the LIFO method is not a permitted inventory method under U.K. GAAP for accounts purposes and is not an allowable valuation method for tax purposes. Presumably, reports received by the [REDACTED] group were converted to LIFO prior to inclusion of any data from those reports in the [REDACTED] group's financial statements, which were prepared on the LIFO basis.

As a result of the LIFO election, [REDACTED] earnings and profits for its taxable year ended [REDACTED] were decreased by \$[REDACTED], a [REDACTED]% reduction.

On [REDACTED], [REDACTED] paid a dividend of \$[REDACTED] to [REDACTED] which paid a like amount to [REDACTED]. [REDACTED] paid a slightly greater amount to its U.S. shareholders. [REDACTED] had the following earnings and profits amounts:

Year ended	(000s)		
	Pre-tax E&P	TAX	E&P
	£	£	£

This is the first dividend that [REDACTED] has paid to the [REDACTED] group.

[REDACTED] has never had any subpart F income. In addition, it has never been engaged in a United States trade or business which would have required it to file a Form 1120F. Also, less than [REDACTED] of [REDACTED] gross income for the year ended [REDACTED] was from U.S. sources.

Section 1.964-1(c)(1)(ii) provides that certain tax adjustments must be made to the profit and loss statement of the foreign corporation for purposes of determining its earnings and profits. One of those adjustments is that inventories shall be taken into account in accordance with the provisions of sections 471 and 472 as modified by section 312(n)(4).

Section 472(a) authorizes the use of the LIFO inventory method for Federal income tax purposes. For purposes of computing earnings and profits, however, section 312(n)(4) provides, in effect, that a foreign corporation may not use LIFO. If a foreign corporation, such as [REDACTED], receives less than [REDACTED] of its gross income in a taxable year from U.S. sources, section 312(n)(4) applies only to taxable years of that corporation beginning after [REDACTED], see section 312(n)(8). Accordingly, section 312(n)(4) does not prohibit [REDACTED] use of LIFO in its taxable year ended [REDACTED].

For the first year the LIFO method is used, section 472(c) requires that the LIFO method must also be used in computing income for purposes of reports to shareholders, partners, other proprietors or beneficiaries, and for credit purposes.

Section 472(e)(2) provides that the Commissioner may terminate the taxpayer's use of the LIFO method if the taxpayer uses any method other than LIFO in computing income for purposes of reports to shareholders, partners, other proprietors, or beneficiaries or to creditors in any year subsequent to the first year that the LIFO method is used.

Section 472(g), which was enacted as part of the Tax Reform Act of 1984, provides that all members of the same group of financially related corporations are treated as one taxpayer for purposes of the conformity requirements of section 472(c) and (e)(2).

Since [REDACTED] did not use LIFO for purposes of its books and records and reports to its shareholder, the conformity requirements of section 472(c) and (e)(2) through application of section 472(g) appear to indicate that [REDACTED] may not use LIFO for U.S. income tax purposes, including for purposes of computing its earnings and profits. However, exceptions to the conformity requirement have been recognized. See S. Rept. 98-169, 98th Cong., 2d Sess. 487 (1984) and Rev. Rul. 78-246, 1978-1 C.B. 146 and Rev. Rul. 89-41, 1989-1 C.B. 167 which allow an exception to the conformity requirement where there is a foreign owned group that is engaged in substantial foreign operations. We think that an exception should also apply to a corporation in [REDACTED] situation so that it may use LIFO for U.S. earnings and profits purposes where it does not use LIFO for book and local income tax purposes solely because the laws and GAAP of the country in which it was incorporated or in which it operates does not allow LIFO for those purposes.

In this situation, [REDACTED] elected on behalf of [REDACTED] to apply the rules of section 964 and the regulations under that section for purposes of determining [REDACTED] earnings and profits for section 902 purposes. In example (1) of § 1.964-1 (c)(8), a foreign subsidiary used FIFO for book inventory purposes and used LIFO for earnings and profits purposes. That regulation does not address the conformity requirements of section 472(c) and (e)(2) as extended by section 472(g). Nonetheless, we think that even in light of those requirements the example reaches the right result.

Both Rev. Rul. 78-246, 1978-1 C.B. 146 and Rev. Rul. 88-69, 1988-2 C.B. 124, state that the purpose of the LIFO book-tax conformity requirement is to ensure that the LIFO method conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business which will be made on the basis of U.S. GAAP. See also S. Rept. 98-169, 98th Cong., 2d Sess. 486 (1984). Here, the fact that [REDACTED] domestic related corporations which engage in a similar business have elected LIFO for both tax and book purposes indicates that under U.S. GAAP, LIFO is the best accounting practice in [REDACTED] trade or business for purposes of determining [REDACTED] section 902 earnings and profits. The Supreme Court held in The Goodyear Tire and Rubber Co. v. U.S., 110 S. Ct. 462 (1989), that

foreign affiliates, such as [REDACTED], of U.S. parent corporations must calculate earnings and profits according to U.S. tax principles for purposes of the section 902 deemed paid foreign tax credit and other provisions. Accordingly, we think that [REDACTED] may use LIFO to determine its earnings and profits.


Robert A. Katcher

cc: District Counsel-Manhattan
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